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TREASURY FOR OFFICE OF INTERNATIONAL AFFAIRS LARRY NORTON

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SUBJECT: QUESTIONS LOOM ON CROATIA'S DEBT AS PM ANNOUNCES A  
SALARY FREEZE

11. (SBU) Summary. Prime Minister Sanader has announced his intention to balance the federal budget in 2009 and has called for a salary freeze and cutbacks in Christmas activities in both the government and state-owned industries to achieve this aim. The PM feels he has little room for maneuver in fiscal policy as the possibility of securing credit abroad has evaporated, and the government faces major debt-servicing bills in the very near future. Nevertheless, economic experts here agree that the government has enough financing options domestically, for the moment, to avoid a debt crisis or intervention by the IMF. But they also question whether political horse-trading over salary increases can either balance the budget or help Croatia avoid whatever risks it faces from the world financial crisis. They say Croatia's challenge is not its federal deficit, or even its high household debt, rather the relative inability of the economy to produce sufficiently competitive goods and services to alleviate its severe external imbalances. End summary.

Government Continues to Keep IMF at Arm's Length  
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12. (U) Croatia's gross foreign debt stands at roughly 36 billion euros, or 95 percent of GDP. In a climate of extremely tight credit, the government has been asked repeatedly in the press in recent weeks how it intends to come up with the estimated 700 million euros required to service its debt in the first quarter of 2009. The government has proclaimed loudly and often that it has no need of IMF assistance and will be able to raise necessary capital on the domestic market. Experts with whom we have spoken are not as confident about the future, but agree that the government will try to avoid the IMF except as a last resort. The GoC feels it cannot afford the damage to investor confidence that IMF intervention might conjure up, and fears the political battles that IMF conditionalities might provoke.

13. (SBU) The director of the Croatian Banking Association (HUB) told us that the government will most likely be able to manage the situation without IMF assistance. He said an IMF delegation routinely stops at his office in late fall as one of their country assessment meetings, but that he had not heard from them so far this year. He also pointed to the fact that Croatian banks' assets, along with those of the central bank, are more than able to cover all deposits in the country, and the stock of deposits far exceeds the stock of household debt. Nevertheless, anticipating increased government borrowing needs on the domestic market in the coming months, the central bank has reduced the marginal reserve requirement for Croatian banks.

14. (SBU) The director of the Zagreb Institute of Economics (EIZ) expects little foreign demand for Croatian government

bonds in the near future. With foreign sources of cash drying up, the government will be forced to rely even more heavily on the domestic market to finance its activities. Fortunately, Croatia has four large pension funds that are legally obligated to purchase government securities, and the government has already tapped them to purchase bonds to help it repay 200 million euro in maturing debt by the end of the year. A fifth fund, the Croatian Veterans' Fund, is flush with cash after selling its block of shares in the national oil company INA to Hungarian MOL and will be a likely customer for government debt as well. The GoC will also turn to the domestic loan market which, according to the EIZ director, carries the serious risk of crowding out of private sector lending. The HUB director believes this is one reason for the central bank's decision to reduce the reserve requirement, in order to free more credit for private sector lending in the face of increased domestic borrowing needs by the government.

#### The Grinch who Stole the Christmas Bonuses

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¶5. (U) For fiscal policy there is very little room for maneuver in the environment of tight credit, and Prime Minister Sanader announced on November 12 that the government would attempt to balance the budget for 2009. To achieve this aim, he proposed a one-year freeze on public-sector salaries, including those of employees of state-owned companies. Without the freeze, civil servants were set to receive a negotiated six percent raise. Sanader also proposed foregoing Christmas gifts and cutting back on entertainment and representational spending, though these measures would mostly affect this year's budget, not next

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year's.

¶6. (U) Sanader's plan has sparked a firestorm of criticism, both from unions opposing the idea outright and from economic experts who say the salary freeze will not be nearly enough and that the state must put major infrastructure projects on hold. He has also received a fair amount of ridicule; there have been caricatures of Sanader in the press as the Grinch.

¶7. (SBU) Sanader's response to the criticism has been uneven and tentative. On November 17, press reported that Sanader had appointed a "brain trust" of economic experts to advise him on the financial crisis, among them our contact at EIZ. However, she told us that seeing her name in the newspaper was the first she had heard of the appointment. The PM recently also argued semantics, claiming that his proposal was not a salary "freeze", but rather only a "postponement" of wage increases. Finally, the press on November 18 announced that the PM had backtracked and was now pushing for only a six month freeze, followed by reduced raises of 3 percent.

¶8. (SBU) Also named as a member of the prime ministerial brain trust was the chief economic strategist of the opposition SDP, Ljubo Jurcic. He told us he was happy to offer his advice even though Sanader last year told the press that Jurcic should win a Nobel Prize for idiocy. He said he planned to tell the prime minister that the truly troubling imbalance in the Croatian economy was not the government deficit, but the trade deficit. He recommended putting big-ticket infrastructure projects on hold (such as the Peljesac bridge and the arenas for the 2009 World Handball Championship) in favor of beginning to invest in actual productive industries that would make Croatia more competitive in the world. He did not believe a public sector salary freeze will have much impact except to hurt individual civil servants.

Economic and Political Realities Hurt Prospects for Balanced Budget

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¶9. (U) The government has not yet released the full budget publicly, but is holding meetings with unions and employers to negotiate on Sanader's proposals. The Croatian Employers Association largely supports Sanader's proposals. The unions, however, oppose the salary freeze and have suggested alternative cost-saving measures, such as reducing higher-level state officials' salaries. They have called on the GoC to do more to reduce costs for households and maintain production levels.

¶10. (U) After a meeting with the unions and employers on November 17, Sanader told the press budget expenditures in 2009 would increase by 1.5 billion HRK (\$270 million) in the areas of pensions, welfare benefits, and health care. He said an additional 1.4 billion HRK (\$250 million) increase would be needed for raises if the salary freeze is not approved. Sanader said the government is willing to negotiate on infrastructure projects, officials' pensions and other benefits, as well as managers' salaries and benefits, but stressed that infrastructure work should continue, as it will be a key component of keeping GDP growth from falling below two percent. Analysts have also noted the government will not want to pull back on announced investments in the energy sector and other smaller projects for fear of implications in the local elections scheduled for May 2009.

¶11. (U) In addition to the political challenge of reaching agreement on cost-saving measures, the GoC faces significant fiscal and economic challenges to balancing the budget for ¶2009. The cost of preparing government administration for EU accession remains high and, according to analysis by the EIZ, businesses are increasingly demanding various forms of state aid. The EIZ analysis indicates that subsidies and other expenditures--not salaries--have contributed most to expenditure increases in 2008, and stopping that trend in 2009 will be difficult. On the revenue side, the GoC relies heavily on the value-added tax for revenue and the slow down in economic activity will result in poorer collection in ¶2009.

¶12. (SBU) Comment. Sanader's "cancellation of Christmas" will probably do little to alleviate whatever risk Croatia may face from the world financial crisis. As the EIZ director reminded us, it is not the government deficit, or even high household debt, that matter in Croatia; it is the economy's continuing inability to produce sufficient goods

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and services of value to the world market outside of the tourist industry.  
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